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Corporations - Stock Restriction - Agreement among Members of Close Family Corporation to Restrict Sale of Stock Is Not Void Merely because of Divergence between Option Price and Actual Value of Stock

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CORPORATIONS—STOCK RESTRICTION—AGREEMENT AMONG MEMBERS OF CLOSE FAMILY CORPORATION TO RESTRICT SALE OF STOCK IS NOT VOID MERELY BECAUSE OF DIVERGENCE BETWEEN OPTION PRICE AND ACTUAL VALUE OF STOCK.

Mather Estate (Pa. 1963)

Petitioner filed suit in Orphan's Court to compel specific performance by the executors of a stock option agreement entered into with decedent. The agreement was among three of the stockholders[1] of a close family corporation, which was originally a partnership. By the terms of the agreement the stock was to be offered to the remaining members for one dollar per share on the death of the signer or in the event one of the members wished to sell his stock during his life. The book value of the stock at the time of the agreement was zero while the actual value was not less than fifty dollars. At the time the agreement was sought to be enforced, book value was 444.92 dollars and actual value was not less than 1,060 dollars per share. The Orphan's Court ordered specific performance of the written stock option agreement. On appeal, the Pennsylvania Supreme Court, Justice Cohen dissenting, affirmed and *held* that where the agreement was made between mature members of a family without overreaching or fraud, the agreement was enforceable, and not unreasonable merely because of the discrepancy between option price and actual value at time of sale. *Mather Estate,* 410 Pa. 361, 189 A.2d 586 (1963).

Stock transfer restrictions are limitations binding on the stockholder which prevent him from freely transferring his stock interest in the corporation. They may be imposed by the articles of incorporation, the by-laws or private agreements among the stockholders, or by a combination of these means. The type of restriction generally used is the "first option" or "first refusal" provision by which the stockholder or his executors must first offer the stock to a specified party, in the event of a desire to sell or death, at a price determined by the provision. The optionees have a certain period of time in which to purchase or refuse to purchase. If they refuse or the time lapses, the stock becomes freely transferable. Restrictions may also take the form of consent restraints requiring approval of transfer by certain individuals, restraints limiting transfers to specified classes of persons, buy and sell arrangements or express, absolute restrictions.[2]

1. Charles Mather, his two sons, Victor and Gilbert, and his daughter Josephine were the original members. Charles died in 1928. Gilbert and Victor pursuant to agreement purchased his shares at $50 per share. Charles a grandson entered the picture in 1933. The three men entered into the agreement in question in 1939. Upon Victor's death in 1943, his stock was purchased by Gilbert and Charles. Josephine died in 1953 and her stock was sold to the Company. In 1959, Gilbert passed away, and the sole survivor Charles occasioned the suit by asking to purchase his stock according to the agreement.

2. O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting,* 65 HARV. L. REV. 773, 778 (1952).

Generally, the rule is that a stock transfer restriction is valid if "reasonable."[3] Thus, absolute restrictions of any kind are held unenforceable,[4] as are those which are in effect absolute, including consent restrains[5] and restraints forbidding transfer to competitors or other classes of persons.[6] While the first option type of restriction was early held invalid,[7] more recently it has been considered enforceable although it must be reasonable.[8] First refusal provisions may be justified by the fact that after the option period, the stock is free of all restraint.

One commentator has suggested that the underlying test of whether a restriction is reasonable or not is to be decided by determining whether the restraint is so needed by the particular enterprise as to override the policy of free alienation of stock.[9] The specific factors which the courts have considered in determining reasonableness are more varied, however.[10] The price-value differential, the purpose of the restriction, the size of the corporation and the degree of restraint seem to be the major factors.

In *Palmer v. Chamberlin,*[11] where the option price was fixed at book value, the executrix argued that this price was too low in light of the earning record of the company. The court upheld the restriction as reasonable suggesting as a test for unreasonableness that "the difference between [the stipulated price formula] and fair market value must be so great as to suggest fraud, mistake or concealment in the nature of fraud."[12] The implication is that no provision made in good faith can be voided merely because of price considerations. Another example of the length to which the courts may go in condoning a price inadequacy is *Allen v. Biltmore Tissue Corp.*[13] In that case, a by-law provided for an option price to be the same as the original purchase price. The court said that to be invalid, more than mere disparity between option price and current value of the stock must be shown.[14]

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3. BALLANTINE, CORPORATIONS 779 (rev. ed. 1946); 12 FLETCHER, PRIVATE CORPORATIONS § 5453 (rev. vol. 1957); O'Neal, *supra* note 2, at 777. For numerous cases see, 61 A.L.R.2d 1318 (1958); 65 A.L.R.2d 1159 (1930).
4. See authorities cited note 3 *supra.*
5. Miller v. Farmers' Milling & Elevator Co., 78 Neb. 441, 110 N.W. 995 (1907); Fisher v. Bush, 35 Hun. 641 (N.Y. Sup. Ct. 1885); ROHRLICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES 114 (3d ed. 1958).
6. See, *e.g.,* Kretzer v. Cole Bros. Lightning Rod Co., 193 Mo. App. 99, 181 S.W. 1066 (1916); BALLANTINE, CORPORATIONS 778 (rev. ed. 1946).
7. Victor G. Bloede Co. v. Bloede, 84 Md. 129, 34 Atl. 1127 (1896); Moore v. Bank of Commerce, 52 Mo. 377 (1873).
8. Searles v. Bar Harbor Banking & Trust Co., 128 Me. 34, 145 Atl. 391 (1929); Baumohl v. Goldstein, 95 N.J. Eq. 597, 124 Atl. 118 (Ch. 1924); Allen v. Biltmore Tissue Corp., 2 N.Y.2d 534, 141 N.E.2d 812 (1957).
9. O'Neal, *supra* note 2, at 779.
10. See, HORNSTEIN, CORPORATION LAW AND PRACTICE 243 (1959); Barron, *Arrangements — Validity and Enforcement of Restrictions on Share Transfer and Buy-Out. Various Types of Restrictions in Ohio,* 31 U. CINC. L. REV. 266, 267 (1962); O'Neal, *supra* note 2, at 779.
11. 191 F.2d 532 (5th Cir. 1951).
12. *Id.* at 541.
13. 2 N.Y.2d 534, 141 N.E.2d 812 (1957).
14. 141 N.E.2d 812, 817 (1957).

The purposes of the specific restriction either as set out in the provision or as found by the court often play the most important role in the decision as to reasonableness of the restriction. A close corporation has been defined as one wherein all the outstanding stock is owned by those members of the firm (or members of their immediate family) who take most active part in the control and management of the corporation.[15] The elements of every corporation are theoretically centralized management in a board, continuity of life, even after death of an important member and free alienability of stock.[16] The incorporators of a close corporation seek to preserve the more desirable partnership features of highly personal intra-business relations and the right to choose associates, both of which conflict with one element of corporateness—free alienability of stock. The shareholders in a close corporation are in constant and intimate contact with one another. Their decisions are made informally and frequently without any regard to their actual holdings. Thus, stockholders in such ventures often have a real desire and a good reason to restrict the membership in the corporation. In addition, the members may wish to protect themselves against incompetent shareholders or those whose personalities may clash with the present members.

In *Lawson v. Household Finance Corp.*,[17] the court in upholding a first option agreement considered whether the restriction was "necessary or convenient" to the attainment of the object set forth in the charter. The corporation in question was engaged in making small loans not exceeding $300, without security, upon the reputation of the borrower. The court said that this restriction was "necessary or convenient," noting that the business was a "precarious" one, apparently meaning that the members of the corporation had to be competent and trustworthy. But a restraint for ten years on alienation of voting trust provisions was held unreasonable in *Tracey v. Franklin*.[18] The court there reasoned that where there was no particular purpose to benefit the corporation or other stockholders or to do anything other than solidify ownership in the agreeing parties, the purpose was legally insufficient to support the restraint.

A restriction requiring the consent of the directors was sustained in *Penthouse Properties, Inc. v. 1158 Fifth Ave., Inc.*[19] Since the corporation involved was a cooperative apartment house, the decision can be justified by the peculiar nature of the corporation. If, as suspected, the courts go on a case to case basis, there is little to guide an attorney in preparing a restriction.[20]

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15. ROHRLICH, *op. cit. supra* note 5, at 109.
16. Hornstein, *Judicial Tolerance of the Incorporated Partnership*, 18 LAW & CONTEMP. PROB. 435, 441 (1953).
17. 17 Del. Ch. 343, 152 Atl. 723 (Sup. Ct. 1930).
18. 31 Del. Ch. 477, 67 A.2d 56 (Sup. Ct. 1949).
19. 256 App. Div. 685, 11 N.Y.S.2d 417 (1939).
20. Painter, *Stock Transfer Restrictions: Continuing Uncertainties and a Legislative Proposal*, 6 VILL. L. REV. 48, 58 (1960). The author makes a probing analysis of several cases, enumerating all the uncertainties to which the counsellor is subjected and proposing action by legislation which might solve the problem.

The rationale for the rule against restrictions is that stock is personal property, and traditionally restraints on the alienation of personal property have not been favored.[21] It has been suggested that restraints are held to contravene public policy because they may be socially and economically unsound.[22] Outside of this very general statement, the courts do not provide any further enlightenment. The premises are assumed and the cases are decided accordingly.[23] Logically, the property concept of stock should prevent any restriction, but reasonable restrictions have been enforced.

The stockholders, in spite of statutory provisions, may also be considered as "creators of the company's constitution and therefore . . . the stock certificates are essentially contractual choses in action."[24] Justice Holmes in upholding a by-law restriction requiring a first option observed that the purchase of stock creates a personal relation analogous to a partnership, and that "[n]otwithstanding decisions under statutes . . . there seems to be no greater objection to retaining the right of choosing one's associates in a corporation than in a firm."[25] Thus, some courts have emphasized the contractual aspect of the provision restricting the transfer and have directed that an arbitrator be appointed to value stock for purposes of sale to optionees,[26] or have prevented a sale of stock unless the vendor conformed to the restrictions.[27] Other cases have reasoned that although by-laws imposing restrictions may be invalid, the restrictions may be enforced against those assenting to the by-laws as if imposed by a separate agreement.[28] A projection of this reasoning would allow those not assenting to the by-law to act as they pleased in regard to the restriction.

Several controlling considerations may have been neglected in the instant case. The majority merely assumed that the purpose of the restriction was valid, without analyzing the appropriate factors in determining its validity. Although the agreement was doubtless the intent of the parties, it may well have been subjected to closer scrutiny, if the "special circumstances" requirement of the *Lawson* case or the reasoning of the *Tracey* case had been applied. It should be noted, however, that the purpose of the contract in the instant case is related to that of choosing one's associates, which restrictive provisions usually contain as justification for their imposition, and which has been upheld as a valid purpose. Thus, although the court's decision would probably have been unchanged had it analyzed the purpose issue fully, its seeming reluctance to treat the issue indicates a

21. FLETCHER, *op. cit. supra* note 3, at § 5452; Cataldo, *Stock Transfer Restrictions and the Closed Corporation*, 37 VA. L. REV. 229, 232 (1951). Some courts will have little difficulty in deciding whether stock is personal property or not. See, *e.g.*, PA. STAT. tit. 15 § 134 (1958): "The stock of every corporation created under the provisions of this statute shall be deemed personal property. . . ."
22. Cataldo, *supra* note 21.
23. Painter, *supra* note 20, at 49 treats the early handling of the problem rather extensively.
24. Gower, *Some Contrasts Between British and American Corporation Law*, 69 HARV. L. REV. 1369, 1377 (1956).
25. Barrett v. King, 181 Mass. 476, 479, 63 N.E. 934, 935 (1902).
26. Fitzsimmons v. Lindsay, 205 Pa. 79, 54 Atl. 488 (1903).
27. Doss v. Yingling, 95 Ind. App. 494, 172 N.E. 801 (1930).
28. Searles v. Bar Harbor Banking & Trust Co., 128 Me. 34, 145 Atl. 391 (1929).

desire to uphold such agreements notwithstanding what proper analysis might uncover.

Secondly, even ignoring the vast disparity between option price and purported actual value at time of *sale,* as the *Allen* case suggests should be done, the court should have considered the disparity between option price and purported actual value at time of *contract.* Although the *Allen* and *Palmer* cases formulated criteria which would allow any price to be reasonable, they are easily distinguishable. The restriction here is extremely close to an absolute restraint, resembling one requiring the consent of members of the corporation before transfer to outsiders. The total contract price is a mere 501 dollars as contrasted with purported actual value at the time of suit in excess of 500,000 dollars and at time of contract of over 25,000 dollars. Thus, it hardly seems realistic to contend that the optionees might fail to exercise the option or that the parties could have altered the price before the time of sale.

Although the decision cannot be justified by its rationale, perhaps it can be justified by its policy implications. The attitude of the legislature in failing to distinguish between close corporations and publicly held ones has largely frustrated those partnerships that seek corporate form, but wish to retain a good deal of the substance of the partnership. So, the members impose restrictions on transfers in an attempt to have the advantages of both forms of operation.

At best, the rationale behind the rule of reasonable restrictions is weak. Granting that stock is personal property, as some statutes command, and ignoring its contract implications, it is still not at all clear why the same rules should apply to stock as to tangible items. Ownership of a corporation is obviously something very different from ownership of a desk or a tool or even land. The courts have recognized the clear divergence by allowing reasonable restrictions, but thus far no court seems to have been so bold as to justify its decision by ruling that incorporated partnerships are perfectly valid in the absence of a specific statute. Holding a restriction invalid makes even less sense when, as in this case, the parties have expressly agreed to it, without coercion from the by-laws and without evidence being produced to show that the contract was intended to defraud creditors or any interested party.

In addition, since the parties in a close corporation can choose one another before incorporating, why should they not also be able to agree to prevent the entry into the firm of an undesirable after incorporating? They could have easily accomplished the same purpose through a partnership, though without the advantages of a corporate form. As for the low price, the parties entered into the agreement unaware of future stock prices and future growth of the business. They may well have been reluctant to set a price which the survivors might be unable to afford, or may have been apprehensive of what one party might do to effect a sale since there is no standard market for the stock of a close corporation. A corporation such as this is a partnership in corporation clothes, and if as